Supreme Court, U.S.
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No.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1996

MARY A. BUCHANAN, individually and as personal representative for the estate of GORDON BUCHANAN, JR.,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Whether the Seventh Circuit erred in holding that a taxpayer's nonbusiness bad debt was not worthless because the taxpayer should have foreseen that the debtor would repay a portion of the debt with funds obtained by fraud.

2. Did the Seventh Circuit change the standard for determining whether a debt is worthless by ruling that the taxpayers' entitlement to a deduction depended not on the debtors' actual financial condition, but on fortuitous events such as the debtors' use of funds that were improperly diverted from payroll tax trust funds, and from a decedent's estate, to make some payments on the debt?

LIST OF PARTIES

Petitioner:

MARY A. BUCHANAN, individually and as personal representative for the estate of GORDON BUCHANAN, JR.

Respondent:

UNITED STATES OF AMERICA

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Petitioner Mary A. Buchanan, individually and as personal representative for her late husband's estate, respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Seventh Circuit, entered in this cause on June 20, 1996.

OPINIONS BELOW

The opinion of the Court of Appeals for the Seventh Circuit is reported at 87 F.3d 197 (1996). It appears at page 1 of the appendix ("App.").

The Memorandum and Order of the United States District Court for the Northern District of Illinois, Eastern Division (J. Moran, Chief Judge) is reported at 892 F. Supp. 1073 (1995). It is reprinted at App. 11. The District Court's final judgment order is reprinted at App. 30. The order denying Petitioner's Motion to Clarify the Record is reprinted at App. 10.

JURISDICTION

Gordon Buchanan, Jr. ("Gordon") and Mary Buchanan (collectively, "the Buchanans") brought this action seeking a refund of federal income taxes for 1986 and 1987. The District Court, in a Memorandum and Order dated June 27, 1995, granted the Buchanans' motion for summary judgment and denied the motion by Respondent ("the Government") for the same. Because the District Court's judgment did not specify the amount of the Buchanans' tax refund, the Court of Appeals dismissed the Government's appeal (and the Buchanans' cross-appeal dealing with attorneys' fees). 82 F.3d 706 (7th Cir. 1996).

On May 6, 1996, the District Court entered a final judgment in favor of the Buchanans in the amount of $542,451 plus interest. App. 30. The Government prosecuted a new appeal, and the Buchanans a new cross-appeal. On June 20, 1996, the Court of Appeals for the Seventh Circuit issued its opinion reversing the District Court's judgment, and holding that the Government was entitled to summary judgment. App. 1. Petitioner (Gordon having died during the pendency of the appeal) filed a Motion to Clarify the Record, which the Court of Appeals denied on July 30, 1996. App. 10.

This Petition is being timely filed within ninety days of the Court of Appeals' June 20, 1996 judgment (Supreme Court Rule 13). This Court has jurisdiction to review the Seventh Circuit's judgment pursuant to 28 U.S.C. § 1254(1).

STATUTE INVOLVED

I.R.C. (26 U.S.C.) § 166(d)

(d) Nonbusiness debts.—

(1) General rule.— In the case of a taxpayer other than a corporation—

(A) subsection (a) shall not apply to any nonbusiness debt; and

(B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 1 year.

(2) Nonbusiness debt defined.— For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than—

(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

STATEMENT OF THE CASE

The Buchanans' daughter, Molly, was married to Stewart Peacock ("Peacock") until Molly's death in June 1986. Peacock was the sole shareholder of a jewelry store named Spaulding & Company ("Spaulding").

By May 1986, the First National Bank of Chicago ("Bank") had loaned Spaulding $1.8 million. Spaulding and Gordon were co-obligors of this debt, and the debt was collateralized by Gordon's Sohio stock. When the Bank learned in May 1986 that Spaulding was having financial problems, it refused to extend further credit to Spaulding. At around the same time, the Bank threatened to sell Gordon's Sohio stock to pay off the debt, unless Gordon signed a note making him the *sole* obligor to the Bank.

Also during this time period, there were rumors of a possible tender offer for Sohio stock at a highly inflated price. Because a premature sale by the Bank of Gordon's stock would have deprived Gordon of the benefit of such a takeover, Gordon chose to become the sole obligor. He tendered more Sohio stock to the Bank to secure an additional $300,000 loan; turned this money over to

Spaulding; and signed a promissory note of $2.1 million, secured by the Sohio stock in the Bank's possession. Gordon and Peacock intended Gordon's status as sole obligor to be a short-term arrangement until Spaulding could find another lender to pay off the Bank's loan. Although Spaulding had no obligation to the Bank after this restructuring, it made the monthly interest payments on Gordon's new loan.

In April 1987, British Petroleum made a tender offer for Sohio stock. Gordon borrowed money from a brokerage house so he could pay off the Bank and redeem his Sohio shares. He then sold the Sohio stock and repaid the brokerage house's loan with a portion of the proceeds.

In June 1987, with Spaulding having been unable to secure new financing, Spaulding formalized its obligation to Gordon. It executed a note to Gordon for the $2.1 million plus interest, guaranteed by Peacock. Spaulding's inventory and receivables, and Peacock's Spaulding stock, were pledged as security.

From June 1987 until August 1988, Spaulding made the required monthly payments on this instrument. As the Buchanans subsequently learned, however, the source of these payments was not Spaulding's operating cash flow or other assets. Rather, Spaulding had obtained the funds to make these payments by "borrowing" or misappropriating a) payroll tax trust funds, and b) the assets of Molly's estate. After Spaulding filed for bankruptcy in April 1989, moreover, the bankruptcy court ordered Gordon to return, as avoidable preferences, the May-August 1988 payments. That court ruled that

Spaulding had been insolvent since at least July 31, 1986, and stripped Gordon of his secured status.

On December 23, 1988, and January 5, 1989, the Buchanans timely filed amended returns for tax years 1986 and 1987. In those amended returns, the Buchanans claimed that Spaulding's $2.1 million debt to them had become worthless in those years. They sought to deduct the debt pursuant to IRC § 166(d) (nonbusiness debts). Unlike business debts, which can be deducted under § 166(a)(2) to the extent they are "partially worthless," nonbusiness debts can be deducted only when they become wholly worthless. The write-off for a nonbusiness bad debt, moreover, is considered a short-term capital loss. Since the Buchanans had realized large capital gains in 1986 and 1987, the nonbusiness debt deduction on the amended returns significantly reduced their tax liability for those years.

The Internal Revenue Service denied the refund claims on June 5, 1991. Two weeks later, the Buchanans filed this action for a tax refund, properly invoking the jurisdiction of the District Court under IRC §§ 6532(a)(1) and 7422(a), and 28 U.S.C. § 1346(a)(1).

Chief Judge Moran of the District Court denied the Government's motion for summary judgment and granted the Buchanans' cross-motion. He held that the Buchanans were entitled to the refund because there was no genuine fact issue as to either 1) the genuineness of Spaulding's indebtedness to Gordon, or 2) the worthlessness of the debt in 1986 or 1987.

On the first point, the Court noted that Gordon had expected repayment from Spaulding, and that Spaulding considered itself obligated to repay Gordon and intended

to do so. The Court rejected the Government's contention that the debt was not bona fide because it lacked value when created. Judge Moran pointed to the undisputed evidence that Gordon reasonably believed Spaulding could repay the $2.1 million—in particular, that he was privy only to the financial information Peacock related to him, and that he thought Spaulding would pay off the debt in short order with a loan from a different bank.

With respect to the debt's worthlessness, the Court acknowledged that the Buchanans would not be entitled to the deduction if the nonbusiness debt had become only partially worthless during the tax year. Compare IRC §§ 166(a)(2) and 166(d). The Court further recognized that deductibility turned on the circumstances "as they existed in 1986 and 1987, even though those circumstances may not have been fully disclosed until later, and we should not consider the impact of any subsequent events that could not reasonably have been anticipated in 1986 and 1987." App. 23.

Employing this approach, the Court found the worthlessness of Spaulding's debt to the Buchanans in 1986 or 1987 to be undisputed. Judge Moran found that Spaulding's tax returns showed liabilities far in excess of assets, with the company operating at a net loss and no reasonable likelihood that Spaulding "would ever be able to cover its ballooning debt." App. 23.

The Court enumerated seven factors supporting this conclusion. First, the bankruptcy court found that Spaulding was insolvent for bankruptcy purposes in 1986. Second, the Bank was unwilling to extend further credit, and instead demanded repayment. Third, Spaulding was unable to procure financing from another lender.

Fourth, the Buchanans' expert demonstrated without rebuttal that by 1986, Spaulding was not a going concern and could not discharge its short-term debt. Fifth and sixth, Spaulding was having difficulty making payroll, was issuing IOUs to creditors, and was substantially behind on payroll taxes and rent payments. The seventh and perhaps most important factor was that as of 7/31/86, a liquidation of Spaulding "would have wiped out Spaulding's unsecured creditors, and that is Gordon's status by determination of the bankruptcy court." App. 24.

The Court rejected the Government's argument that Spaulding's payments on the debt into 1988 demonstrated that the debt had value in 1986 and 1987. It stated (App. 24):

> We agree with the government that generally a debtor's payments on the debt militate strongly against a finding of worthlessness. This case is different, however, because Spaulding was meeting its interest obligations only because of the infusion of funds from Molly's estate and because it was wrongly withholding payroll taxes. Whether the funds from Molly's estate is considered a loan, which would have increased Spaulding's indebtedness, or misappropriated, which would have resulted in taxable income which also would have increased Spaulding's and Peacock's liabilities, it is clear that Spaulding was meeting its interest obligations only by going further in debt.

Similarly, the District Court held that the Buchanans' subsequent recoveries from Spaulding's and Peacock's bankruptcy estates did not prevent the debt from being deemed worthless in 1986 or 1987. Rather, the Court recognized that the issue is whether the Government has

shown "that these recoveries were reasonably foreseeable at the end of the tax years in question."

The Court noted that Peacock had impermissibly transferred $648,000 from Molly's estate to Spaulding. The Government could have treated this conversion "as income both to him and to Spaulding, with a significant diminution of the assets of both for the priority payment of additional taxes." In other words, there was "an unexpected receipt by Spaulding of far more than Gordon's ultimate recovery and a potential significant tax liability of Peacock's that was never realized." App. 26. Accordingly, the Court viewed Gordon's partial recovery as a "fortuitous" event that did not "change the fact that no one could reasonably believe that the debt had any value in 1986 or 1987." *Ibid.* "Spaulding was so hopelessly insolvent in those years," the Court continued, "that the possibility of repayment was too remote to postpone a finding of worthlessness." App. 26-27. Indeed, the District Court noted that the Government had not challenged the claim by Molly's estate that Spaulding's/Peacock's indebtedness to *it* was worthless in May 1987. App. 26.

As the District Court recognized, allowing the bad debt loss here would hardly provide the Buchanans with a windfall. Under § 111 of the Code, a taxpayer who unexpectedly recovers part of a debt that has been deducted as worthless must declare the recovered funds as income. Accordingly, every dollar the Buchanans received from Spaulding and the bankruptcy estates would constitute

taxable income, as the Buchanans had acknowledged in their amended returns.[1]

After the District Court entered a final judgment in favor of the Buchanans in the amount of $542,451 plus interest, the Government prosecuted its appeal to the Seventh Circuit. That Court reversed the entry of judgment for the Buchanans, and instead held that the Government was entitled to summary judgment.

The Court of Appeals did not quarrel with the genuineness of the debt at issue. Nor did Judge Posner's opinion quarrel with the notion that an unforeseeable recovery would be consistent with the debt having been worthless, within the meaning of § 166(d), in 1986—although it used such phrases as "miraculous, unforeseen, unforeseeable, totally unexpected," App. 4, and "manna from heaven" or "lottery winnings," App. 7, to express this thought.

The Court of Appeals similarly acknowledged that the Buchanans "should not have received any of" the money that they did recover from Spaulding and the bankruptcy estates. App. 3. It explained that Peacock "had become the trustee of his deceased wife's estate. He improperly siphoned assets of the estate into his failing business, where they were used to pay some of his creditors, including his former father-in-law. He improperly diverted

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[1] *See* Treas. Reg. § 1.166-1(f): "Any amount attributable to the recovery during the taxable year of a bad debt, . . . which was allowed as a deduction from gross income in a prior taxable year shall be included in gross income for the taxable year of recovery, except to the extent that the recovery is excluded from gross income under the provisions of § 1.111-1, relating to the recovery of certain items previously deducted or credited. . . ."

payroll taxes to the same creditors. Without these improper infusions of capital into the failing jewelry business it is unlikely that the taxpayers would have received anything on their debt unless they had sued the jewelry business promptly in 1986 and obtained a judgment, putting them ahead of the business's other unsecured creditors." App. 3. The Court of Appeals then conceded, App. 6, that Gordon's failure to sue in 1986 may have been reasonable—no doubt in light of the facts that at that time, Gordon was unaware of Spaulding's perilous financial condition and of Peacock's improper diversions, and was receiving timely payments on the debt!

The Seventh Circuit nevertheless concluded that "considering the familial setting," the Buchanans' partial recovery was foreseeable and they were not entitled to the bad debt deduction. This was the Court's reasoning (App. 7-8):

> [S]houldn't the partial recovery of the debt be classified with lottery winnings as a totally unexpected mode of recovering a debt, a pure windfall, manna from heaven—and hence consistent with the theory that the debt really became worthless in 1986? We think not, considering the familial setting. The son-in-law funneled money from his wife's estate and the Internal Revenue Service to the wife's parents. This could not be thought a totally unforeseeable consequence of his inability to repay the parents, his former in-laws, directly. He would at least be keeping the money within the family, and he might therefore hope to see some of it himself.

This surmise was based not upon any actual evidence about Peacock's motivations or the familial relationship, but instead upon the Court's own generalized surmising about bonds between former in-laws.

REASONS FOR GRANTING THE WRIT

The Seventh Circuit's decision stands for the proposition that a nonbusiness debt cannot be deemed worthless if the debtor might repay a portion of the debt by diverting or misappropriating someone else's money. This proposition is contrary to precedent and logic. It would eviscerate the nonbusiness debt provisions of § 166(d)(1)(B) in "the familial setting" (App. 7) even though, as the Seventh Circuit acknowledged, "the domain of the nonbusiness debt is limited largely to the family," App. 2.

The Court of Appeals' approach is plainly wrong. By distorting and changing the rules applicable to evaluating a debt's worthlessness, the decision below resolves an important question of federal law in a manner that cries out for review and correction by this Court.

The Decision Below Requires Taxpayers Making a Determination of Worthlessness to Anticipate that Debtors Will Misappropriate Funds in Order to Repay Part of the Debt. This Ruling Conflicts with Settled Principles and Warrants Review.

A taxpayer is entitled to take a deduction for a nonbusiness bad debt if he, "in the exercise of 'sound business judgment' based upon as complete information as was reasonably obtainable, could have determined that the debt in fact had become worthless in [that tax year.]" *Estate of Mann*, 731 F.2d 267, 276 (5th Cir. 1984). As the Eighth Circuit stated in *Riss v. Commissioner*, 478 F.2d 1160, 1166 (8th Cir. 1973):

> If collection seems hopeless to a reasonable man knowledgeable in the field of business, a deduction is justified. *See* Loewi & Co. v. Commissioner, 232 F.2d 621, 625 (7th Cir. 1956). Nothing in the Code or Regulations requires a taxpayer to refrain from

> charging off a debt that he honestly and reasonably believes to be uncollectible, merely because the debtor might at some time and in some manner find himself able to pay.

While the Government contested many points below, the District Court and the Court of Appeals both found that the Buchanans would have collected nothing on their debt if not for Peacock's diversion of monies that belonged to the Government and to his wife's estate. Clearly a reasonable person with knowledge of the debtors' true financial condition in 1986-87, would have viewed the debt to the Buchanans as uncollectible.

The Seventh Circuit nevertheless held that the deduction was not available because the Buchanans, as Peacock's former in-laws, should have foreseen that he would arrange to repay a portion of the otherwise bad debt by misappropriating payroll tax trust funds and the assets of trusts established under Molly's Will.[2] As other courts have recognized, however, "[t]he fact that a debt reasonably determined to be worthless in a given taxable year, is subsequently recovered in part or in full, is not in itself sufficient to prevent the deduction." *Mann*, 731 F.2d at 277. The cases *Mann* cited as examples included one in which a $6 million loan was found worthless even though it was repaid in full four years later; and another in which 13/15ths of the debt was repaid in the year following the deduction. *See also Fincher v. Commissioner*, 105 T.C. 126 (1995) ("Subsequent recoveries do not preclude otherwise valid deductions"); *cf. Halliburton Co. v.*

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[2] Peacock was the trustee but not the sole beneficiary of these trusts; the corpus of the residuary trust, in fact, was primarily intended to benefit Molly's and Peacock's children.

Commissioner, 946 F.2d 395, 400 (5th Cir. 1991) (same approach under IRC § 165, dealing with losses).

The tax laws specifically contemplate the possibility that the taxpayer will recover some of the bad debt after it has become "worthless" within the meaning of § 166(d). Treas. Reg. § 1.166-1(f), and IRC § 111, expressly provide that the subsequent recovery is treated as income in the year of receipt, to the extent that the bad debt deduction conferred a tax benefit upon the taxpayer. *See Textron, Inc. v. United States*, 561 F.2d 1023, 1027 (1st Cir. 1977) ("Later recovery of a properly deducted bad debt does not void the first deduction. . . . Rather, the recovery becomes income in the year of recovery").[3]

This Court made the same point in *Hillsboro Nat'l Bk. v. Commissioner*, 460 U.S. 370, 384, n. 17 (1983), writing: "we already require that the debt be apparently worthless in the year of deduction, see § 166(a)(1), but we often find that the future does not conform to earlier perceptions, and the taxpayer collects the debt. Then, 'the deductions are practical necessities due to our inability to read the future, and the inclusion of the recovery in income is necessary to offset the deduction.' " As *Mann* notes, moreover, it is irrelevant that the deduction first appeared on an amended return filed after the repayments were received. The deduction is "taken" in the tax year to which it relates, not when the return claiming the deduction is filed. 731 F.2d at 278 & nn. 16, 18

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[3] This principle, which the opinion below completely overlooked, answers the Court's purported concern about the fact that the Buchanans are seeking both to deduct the bad debt and to keep the money they received as a result of Peacock's misdeeds.

("worthlessness is viewed as a snapshot, not as an endlessly updated film").

Judge Posner's opinion for the Seventh Circuit gives no weight to the interrelationship between §§ 111 and 166. Instead, it creates a blanket, irrebuttable presumption—sufficient to warrant summary judgment without inquiry into the parties' actual motives or relations—that it is foreseeable that one family member will cheat or steal in order to repay a legitimate debt to another. That presumption applies not only as between in-laws, but even when the funds that the debtor uses to keep his creditors at bay deplete his own children's—the creditor's grandchildren's—inheritance.

The Court of Appeals' remarkable approach cannot, of course, be applied only to situations where the debtor *actually* has misappropriated funds in order to repay his relative. The determination of worthlessness, as *Mann*, *Riss*, the District Court here, and other courts have always recognized, is not to be made in hindsight, but from the facts obtainable at the time. Gordon's obligation to *foresee* that Peacock would obtain repayment funds through illicit means, in other words, cannot be influenced by the fact that we *now* know that Peacock did misappropriate the money.

Under the Seventh Circuit's approach, therefore, no taxpayer may take a nonbusiness debt deduction if his or her debtor is a relative who *could*, through means similar to Peacock's, obtain possession of someone else's money. What similar means the Seventh Circuit would include within its approach is unclear—misappropriation of funds from the debtor's wife and children, the creditor's daughter and grandchildren, and the IRS are

apparently included, but what of insurance fraud, other white collar misconduct, and common theft?

The Seventh Circuit's resistance to the Buchanans' bad debt deduction takes the law on an unnecessary ride to uncharted territory. It forces taxpayers to assume that their family members will engage in improper, even criminal, behavior in order to repay a debt. It likewise puts courts in the inappropriate position of assuming that reasonable people would sooner commit a tortious or criminal act than default on a family debt. This is a strange twist on the concept of family values, and not one that the Code, the Regulations, reported precedent, or any legal or economic theory requires the courts to accept.

CONCLUSION

For the foregoing reasons, this petition for certiorari should be granted, and the decision of the Seventh Circuit should be reversed.

Respectfully submitted,

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